No. 21824

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

JOE R. RAMOS AND MARY RAMOS, APPELLEES

On Appeal From the Judgment of the United States District Court for the Northern District of California

BRIEF FOR THE UNITED STATES AS APPELLANT

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CITATIONS

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OPINION BELOW

The memorandum opinion and order of the United States District Court for the Northern District of California (I-R. 50-72) and the amendment thereto (I-R. 73-74) are not officially reported.

JURISDICTION

This appeal involves federal income taxes. The taxes in dispute for the year 1956 were paid as follows: $57,902.93 plus interest of $8,894.84 on Decem-

ber 15, 1959. (I-R. 39.) Claim for refund was filed on December 15, 1959 (I-R. 39), and was rejected on October 20, 1960 (I-R. 39). The taxes in dispute for the year 1957 were paid as follows: $50,-458.31 plus interest of $4,723.73 on December 15, 1959. (I-R. 40.) Claim for refund was filed on December 15, 1959 (I-R. 40), and was rejected on October 20, 1960 (I-R. 41). Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on July 5, 1961, taxpayers brought an action in the District Court for the recovery of taxes paid for the year 1957. (I-R. 1-4.) Also within the time provided in Section 6532, on September 14, 1961, taxpayers brought an action in the District Court for the recovery of taxes paid for the year 1956. (I-R. 5-8.) Jurisdiction was conferred on the District Court in both cases by 28 U.S.C., Section 1346. The cases were consolidated on April 24, 1962. (I-R. 22) The judgment of the District Court was entered on December 15, 1966. (I-R. 75) Within sixty days thereafter, on February 9, 1967, the United States of America filed a notice of appeal. (I-R. 76.) Within fourteen days thereafter, on February 23, 1967, taxpayers filed a notice of appeal and/or cross-appeal. (I-R. 77.)[1] Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

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[1] Pursuant to the order of this Court dated July 28, 1967, concerning the time for filing briefs in these cases, this brief is confined to the appeal of the United States. Another brief will be filed by the United States in reply and answer to the points raised in the taxpayers' brief which is to be filed on October 9, 1967.

QUESTIONS PRESENTED

1. Whether the District Court erred in holding that there was a valid family partnership composed of taxpayers (Joe R. and Mary Ramos) and their children during 1956 and a valid family partnership composed of taxpayer Joe R. Ramos and the children in 1957 and in failing to hold that there was involved herein a mere assignment of future income arising from the property and services of taxpayers.

2. Assuming *arguendo* that question 1 above should be answered "yes", the further question will arise as to whether the District Court, having found valid family partnerships to have existed during 1956 and 1957, failed to properly allocate the income thereof so as to credit taxpayers with a reasonable return on their capital.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set out in Appendix A, *infra.*

STATEMENT

The basic facts are virtually undisputed (I-R. 54), and, as supported by the record evidence, may be stated as follows:

Taxpayers, Joe R. and Mary Ramos,[2] are husband and wife and reside on a 219-acre ranch near Winters, California. (I-R. 37, 56.) They purchased this

[2] Unless otherwise indicated by the text, the singular "taxpayer" used hereinafter refers to Joe R. Ramos.

ranch in the latter part of 1943 and have lived on and farmed it continuously from that time. (II-R. 6-8, 18.) Approximately 175 acres of the ranch are planted in mature almond trees with the balance being planted in peaches and olives. (II-R. 7.) The land, trees and other improvements which comprised the taxpayers' ranch and the equipment necessary for its operation had a value of $200,000 to $230,000 during 1956 and 1957, the years in suit. (II-R. 129-134.)

Taxpayers' daughter, Dolores Donaldson, was 24 years old in 1956 and by that year had graduated from Sacramento Junior College and was married. (I-R. 38; II-R. 8, 142-143.) From the time she was in high school, Dolores had done the bookkeeping for the ranch as well as for her parents' other business ventures. She was paid for these services (II-R. 10-11, 102, 144-145, 297-300) and in 1955 received $75 for this work (II-R. 296).

Taxpayers' son, Joe S. Ramos, had worked on taxpayers' ranch on weekends and during vacations from school. From the time he graduated from high school, he was paid for his work. (II-R. 10-12, 40, 417.) After he graduated from Sacramento Junior College in June of 1955, he worked on the ranch and was paid accordingly. (II-R. 26, 37-39, 105-106.) On November 22, 1955, Joe S. Ramos went on active duty with the United States Navy and was shortly thereafter transferred to Hawaii. (I-R. 38; II-R. 429-430.) At the beginning of the period in suit, Joe S. Ramos was 21 years old. (I-R. 38.)

Taxpayer's brother, Frank D. Ramos, was foreman of the ranch prior to the years in suit and throughout the period Joe S. Ramos was in the Navy. (II-R. 37-39.)

As of January 1, 1956, a "family partnership" composed of the taxpayers and their children, Dolores Donaldson and Joe S. Ramos, purportedly was to commence.[3] (II-R. 18, 153, 155, 161, 427, 483.) This partnership was to operate taxpayers' ranch for the year 1956, with each of the four partners having a 25 percent interest in the business. (II-R. 18-19, 21, 154-155, 428.) The partnership acquired no interest in the land, trees and other improvements which made up the taxpayers' ranch or in the equipment neecssary for its operation, as these assets were retained by taxpayers. The partnership did not pay any rent in 1956 for these assets. (II-R. 20-21, 155-156, 483-484, 488.) Neither Dolores Donaldson nor Joe S. Ramos contributed any capital to the partnership for 1956. (II-R. 20, 301-302.)

During 1956, the ranch continued to operate under the name of "Joe R. Ramos." (II-R. 99; Ex. 35.) The expenses for operating the ranch for that year were paid from taxpayers' joint checking account with the Bank of America at Winters, with the re-

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[3] For convenience only, the terms "partner" and "partnership" are used occasionally in this brief in referring to the members of the Ramos family in their purported business relationships during the years in suit. The Government does not intend any inference to be drawn therefrom with respect to the validity of those arrangements for federal income tax purposes.

ceipts from the operation of the ranch being deposited to that account. (II-R. 120-121, 238-239; Ex. 6, pp. 2-15.) This account included funds other than partnership funds. (II-R. 236-237.) The accounting records for the 1956 ranch operations were kept on the cash basis and were merely a continuation of the individual records maintained for taxpayers in previous years. (I-R. 43, 63; II-R. 311-312, 318-328, 524-527, 557-558; Ex. 6, pp. 2-15; Ex. 7, p. A.)

The 1956 federal employer's withholding tax return for the ranch employees was filed in the name of "Joe R. Ramos, owner" and under the account number assigned to him.[4] The workmen's compensation report for that year was also filed under taxpayer's name. (Ex. 47, Ex. A.)

Because of his experience, taxpayer was senior partner and "boss" of the partnership. (II-R. 20, 159, 429.) He made the decisions concerning the sale of crops grown on the ranch and generally supervised the ranch operations. (II-R. 302-305.) However, he received no salary or allowance for his work. (II-R. 104, 287, 468.)

Taxpayers' daughter, Dolores, lived in Winters with her husband and worked full time throughout 1956 as a clerk for Pacific Gas & Electric Company.

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[4] On January 28, 1958, Dolores Donaldson advised the District Director that the employer's return for 1956 should have been filed under the name and account number for "Joe R. Ramos & Co." However, that account number was not applied for until November of 1957 and was obtained for a partnership that did not include Mary Ramos as a partner. (Exs. 47, 49.)

(II-R. 98, 143, 159, 293-294.) As compensation for doing the bookeeping for the partnership on a part-time basis, she received a salary of $150 a month. (I-R. 20, 22.)

Taxpayers' son, Joe, was on military duty in Hawaii during 1956 with the exception of the last week in December. (II-R. 26, 288-289, 489.) During that brief stay at home, he did not do any work on the ranch. (II-R. 288.)

The 1956 almond crops was sold on June 26, 1956, by Joe R. Ramos as the seller. (II-R. 23; Ex. 54.)

For 1956, the partnership filed a federal partnership information return in the name of "Joe R. Ramos Co." (I-R. 38; Ex. 42.) This return was filed on the cash basis (Ex. 42) and reflected total receipts of $220,640.68, of which $70,640.48 represented proceeds from the almond crop grown on taxpayers' ranch and sold in 1955. (I-R. 67-68, 70; II-R. 469; Ex. 7, p. A.) The return further reflected expenses of $68,477.04, including depreciation and real property taxes on assets belonging to taxpayer. The net income of $152,163.44, as shown on the return, was divided into four equal shares of $38,040.86, which shares were reported by the purported partners on their individual returns for 1956. (Exs. 43, 44, 45, 46.)

Dolores Donadson's distributive share of the partnership's profit for 1956 was paid to her on February 14, 1957. (I-R. 41; Ex. 14.) She then paid $16,-028.68 to the Internal Revenue Service in payment of her federal income taxes for 1956. (I-R. 42.) In addition, she paid $1,160.34 to the Franchise Tax

Board of the State of California in payment of her 1956 state income tax. (I-R. 41.)

Payment of the distributive share of Joe S. Ramos, who was then in Hawaii, was handled as follows: $17,472.56 was paid to the Internal Revenue Service from taxpayers' joint checking account for their son's 1956 federal income taxes and $19,173.85 was deposited to a savings account maintained in the names of "Ramos, Joe S. or Joe R." in the form of a check drawn on taxpayers' joint account. (I-R. 41; II-R. 124.) Taxpayer then withdrew $2,217.75 from the account he had with his son to pay state and additional federal income taxes for Joe S. Ramos for 1956. (I-R. 43.)

For 1957, a different partnership was purportedly organized to operate taxpayers' ranch. (II-R. 162-163.) A written agreement was entered into by taxpayer and his son and daughter which provided that they would engage in the farming business under the name of "Joe R. Ramos & Co." until January 1, 1962, and that each would receive 33⅓ percent of the profits. Mary Ramos was not a party to this agreement and was not to be a partner in 1957. (Ex. 1.) The partnership agreement, in pertinent part, further provided (Ex. 1):

> 3. *Capital.* The capital of the partnership shall be contributed by the partners, in cash, as follows:

Joe R. Ramos	$15,000.00
Dolores Donaldson	$15,000.00
Joe S. Ramos	$15,000.00

The foregoing capital consists entirely of cash and represents the entire assets of the partnership at the commencement of the calendar year 1957.

* * * *

5. *Salaries of Working Partners.* Joe R. Ramos shall devote full time and attention to the partnership business, and upon his release from military service, Joe S. Ramos will devote such time and attention to the partnership business as he is able. Doroles Donaldson shall render bookkeeping services for the benefit of the partnership. And each of the partners shall receive such monthly salaries as may from time to time be fixed by mutual agreement between them, such salaries to be an allowance of reasonable compensation for services actually rendered to the partnership. Notwithstanding the foregoing, the amount of such salaries shall be subject to the provisions of paragraph .... hereof.

* * * *

7. *Drawing Accounts.* * * * Except as otherwise specifically provided herein, no part of the capital contribution of the partners shall be withdrawn without the unanimous consent of the partners.

8. *Management.* The partnership business shall be managed by the working partners, but in the event of any disagreement between them, the decision of Joe R. Ramos shall be controlling.

9. *Restrictions on Partners.* * * * No partner shall, except with the consent of the other partners, assign, mortgage or sell his share in the partnership or in its capital assets or property, or enter into any agreement as a result of which

> any person shall become interested with him in the partnership, * * *. * * *
>
> 10. *Banking.* All funds of the partnership shall be deposited in its name in such checking account or accounts as shall be designated by the working partner or partners. All withdrawals therefrom are to be made upon checks signed by Joe R. Ramos.

As in 1956, the land, trees and improvements which made up taxpayers' ranch and the equipment necessary for its operations were not transferred to the partnership. (II-R. 20-21, 64; Ex. 1.) However, about the same time the 1957 partnership agreement was signed, a Memorandum of Rental Agreement was entered into by all partners on behalf of "Joe R. Ramos & Co." and by the taxpayers individually. (II-R. 70-71; Ex. 2.) This agreement provided (Ex. 2):

> Joe R. Ramos & Company, a partnership will rent from Joe R. Ramos and Mary S. Ramos, for a two-year period commencing November 1, 1956 and terminating November 1, 1958, approximately 175 acres located near Winters and belonging to the owners. The rent to be paid to owners shall be 25% of the gross sale price of the crops raised thereon during the term and the partnership shall pay all expenses except real property taxes and machinery costs, said machinery to be supplied by owner, except that minor repairs to machinery for maintenance and less than $100.00 shall be paid by the partnership.

Until the end of March, 1957, banking for the partnership was handled through taxpayers' joint account with the Bank of America at Winters. (II-R. 325, 329, 331-332; Exs. 6, pp. 17, 18 and 19, 61, 62.) At that time, taxpayer and his son and daughter each contributed $15,000 to the partnership.[5] These contributions were deposited to the account of "Joe R. Ramos & Co." which was opened at the First National Bank of Dixon. (I-R. 42; II-R. 46-47, 84-85; Ex. 10.) This account and a savings account subsequently opened in the same name could be drawn upon only by Joe R. Ramos or Mary Ramos. (II-R. 52, 91-92, 98, 167, 252; Ex. 5.)

The partnership books for 1957 were kept on the cash basis and in substantially the same form as the books kept for taxpayers in previous years. (I-R. 43; II-R. 320, 323; Ex. 6, pp. 1, 17-31.) A similar set of books was also kept for taxpayers in 1957. (Ex. 7, pp. B, C-I.)

For 1957, business was done mainly in the name of "Joe R. Ramos & Co." (II-R. 99.) A fictitious name certificate listing the purported partners was executed in July of that year and filed with the County

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[5] As was previously noted, the contributions of Dolores and Joe S. in 1957 were derived from the profits of the 1956 partnership. (II-R. 43-46, 49-50, 100, 173-176.) The actual mechanics of making these contributions involved the issuance of checks to the children from taxpayers' account with the Bank of America at Winters (I-R. 41), the depositing of these checks to accounts maintained by the children (I-R. 41-42), and the purchasing of cashier's checks for the funds actually deposited to the account opened in the name of "Joe R. Ramos & Co." with the First National Bank of Dixon. (I-R. 42).

Clerk of Solano County in Fairfield, California, but was not published until September in a local newspaper. (Exs. 3, 4.) The 1957 almond crop was sold under a contract made by "Joe R. Ramos & Co." as seller and payments were made in that name by the purchaser. (Exs. 55, 57, 58, 60.) The federal employer's withholding tax return was filed under the account number obtained for the 1957 partners (II-R. 197; Exs. 37, 49) and the workmen's compensation report for 1957 was also filed in the partnership name (Ex. 36).

Dolores Donaldson, in acting as bookkeeper for the 1957 partnership, did essentially the same work which she had done in prior years for taxpayers (II-R. 322-325) and was paid $150 a month for her work (I-R. 20, 22). Taxpayers' son was not separated from the Navy until October of 1957 and worked on the ranch for only the last three months of the year. He received a salary of $350 per month during this period. (I-R. 38; II-R. 443-444, 446-447; Ex. 24.)

For 1957, a federal partnership information return was filed on the cash basis (Ex. 33) in the name of "Joe R. Ramos & Co." This return reflected total receipts in the amount of $194,206.45, including $157,-088.71 from almonds and other crops which were raised, sold and delivered in 1956. (II-R. 113-114, 361, 363; Ex. 6, p. 1; Ex. 7, p. B.) Rent to Joe R. Ramos in the amount of $48,480.08 [6] and other ex-

[6] The sum of $48,480.08 was paid by partnership receipts of $30,000 and $7,239.41 which taxpayer withheld as advance rent (Ex. 7, p. B) and a check for $11,240.67 which was

penses of $43,044.58 were deducted from the total receipts to arrive at a net income of $102,681.79 for the year.

Dolores Donaldson and Joe S. Ramos each reported $34,227.25, or one-third of the partnership net income, on their individual federal income tax returns for 1957. (Exs. 18, 24.) Taxpayers reported the remaining one-third of the net income and rent in the amount of $48,480.08 on their 1957 federal income tax return. (Ex. 32.)

On February 6, 1958, Dolores Donaldson and Joe S. Ramos each received $15,000 as a partial distribution of the profit reported by the partnership for 1957. (Exs. 26, 27, 30.) No other payments were made to either of them for the remainder of their 1957 distributive shares. (II-R. 350-351, 353.)

On February 10, 1958, Dolores Donaldson and her husband paid a total of $14,622.98 for 1957 federal and state income taxes due in addition to the taxes withheld from their salaries. (Exs. 18, 28, 29.) On the same day, Joe S. Ramos and his wife paid 1957 federal and state income taxes totaling $12,343.30. (Exs. 24, 65.)

The Internal Revenue Service audited the individual returns filed by taxpayers for the years 1956 and

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drawn by the partnership in 1958 (II-R. 551-552). It should also be noted that the sum of $48,480.08 was approximately 25 percent of the gross crop receipts received in 1957 and was determined without regard to the period in which the crops were grown, whereas the rental agreement purportedly in effect for 1957 provided for only 25 percent of the gross receipts for crops grown on the premises after November 1, 1956. (Ex. 2.)

1957 and determined that no valid "family partnership" existed in either year for federal income tax purposes. Additional income taxes and interest were therefore assessed against and paid by taxpayers for the years and in the amounts now in suit. (I-R. 39-40.) Corresponding refunds were made to taxpayers' son and daughter and their respective spouses for taxes which they had paid on the partnership income. (II-R. 405-406; Exs. 72, 75, 78, 79, 80.)

After their refund claims were rejected by the District Director of Internal Revenue at San Francisco, taxpayers filed the instant suits. (I-R. 39, 40-41.)

The cases were consolidated for trial and tried to the District Court sitting without a jury. The District Court held (I-R. 53) that a valid family partnership existed during 1956 composed of taxpayers and their children and during 1957 composed of taxpayer Joe R. Ramos and the children. And the District Court determined the "corrected" partnership income and the distributive shares of the partners on the basis of various adjustments, including the allowance of 25 percent of the crop receipts as rent owing to taxpayers by the partnership for the taxable years and the allocations in equal amounts among members of the 1956 partnership of the sum of $157,088 received in 1957 from crops sold in 1956. (I-R. 70-74.)

The Government appeals to this Court and its specification of errors relied upon as grounds for reversal are stated below.

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court erred in finding and concluding that, during the year 1956, a valid family partnership composed of taxpayers and their children, Dolores Donaldson and Joe S. Ramos, existed and operated the Ramos Home Ranch.

2. The District Court erred in finding and concluding that, during the year 1957, a valid family partnership composed of taxpayer Joe R. Ramos and his children, Dolores Donaldson and Joe S. Ramos, existed and operated the Ramos Home Ranch.

3. In the alternative, and assuming that a valid family partnership existed during the year 1956, the District Court erred in allocating only 25 percent of the partnership's crop receipts for 1956 to taxpayers for the use by the partnership of the land, trees and equipment which made up the Ramos Home Ranch and which were owned by taxpayers.

4. In the alternative, and assuming that a valid family partnership existed during the year 1956, the District Court erred in allocating in equal amounts among members of the 1956 partnership, the sum of $157,088.71 received in 1957 from crops sold in 1956.

5. In the alternative, and assuming that a valid family partnership existed during the year 1957, the District Court erred in recognizing the rental agreement between taxpayers and the partnership in determining the amount allocable to taxpayers for the use during the year 1957 by the partnership of the land, trees and equipment which made up the Ramos Home Ranch and which were owned by taxpayers.

SUMMARY OF ARGUMENT

The resolution of the problems as presented by the family partnership situation involves two basic principles of taxation: (1) that the assignment of the right to receive future income, whether from personal services or from property, will not shift the burden of taxation of such income, when realized, from the assignor to the assignee and, (2) on the other hand, that a completed gift of income-producing property will effectively shift the tax incidence of the income thereafter derived from such property to the donee.

The record evidence is quite clear that in spite of the Supreme Court's requirement in *Commissioner* v. *Culbertson*, 337 U.S. 733, that there be a present contribution of either capital or services, taxpayers, in their attempt to show the validity of their family partnership, have established little more than a desire to commence operating as a family partnership in 1956. The evidence shows that in 1956 the ownership of the land, trees and improvements, which comprised taxpayer's ranch and the equipment necessary for its operation was retained by taxpayers; that all banking was done through taxpayers' joint checking account; that the bookkeeping practices remained the same and separate partnership accounts were not maintained; that the ranch was operated in taxpayer's name; and that taxpayer supervised and managed the ranch full-time. Moreover, neither of the children contributed any capital to the purported partnership; taxpayers' son was absent from the ranch because of military service even before the

partnership was to commence operating; and taxpayers' daughter merely continued her part-time bookkeeping duties and was paid therefor.

A new partnership was entered into in 1957 in which Mary Ramos was no longer a partner. Taxpayer continued as manager of the partnership and, for at least the first nine months of that year, was the only partner to render any substantial service in the production of partnership income. The land, trees and equipment which comprised the ranch remained taxpayers' property. Notwithstanding execution of a partnership agreement at the beginning of the year, no changes were made in the banking or the bookkeeping for the ranch until the end of March, and even then the partnership bank accounts could be drawn upon only by taxpayer and Mary Ramos, who was no longer a partner. Taxpayers' son worked only at the very end of the harvest and was paid for his work. Taxpayers' daughter continued to do the bookkeeping on a part-time basis and was paid therefor. The fact that there was a written partnership and rental agreement, that the name "Joe R. Ramos & Co." was used, and that each of the children allegedly contributed $15,000 as capital (which they received as part of their distributive share of the 1956 partnership *profits*) did not make any real difference in the operation of taxpayers' ranch for 1957.

Although the children rendered some service to the partnership, still, they were paid therefor and they contributed as partners nothing which was of benefit to or furthered the legitimate business purposes of the partnership. Hence, they should not be recog-

nized as partners; and taxpayers' attempt to use their family to minimize their tax burden must be recognized as being merely an attempt to assign future income while retaining ownership of the income-producing assets. In failing to recognize that there was involved an attempt to assign income and in upholding the validity of the partnership, the District Court committed a reversible error.

Having upheld the validity of the family partnerships, the District Court erred in allocating to taxpers, as owners of all the operating assets used by the partnership, only 25 percent of the crop income for 1956; in allocating equally among the 1956 partners the sum of $157,088.71 which was received in 1957 from the sale of 1956 crops; and in recognizing the rental agreement for 1957, in that, by so doing, the court failed to uphold the basic tenet of income taxation that income from property is taxable to the person who owns or controls the property and failed to allocate the partnership income as required by Section 704(e) of the Internal Revenue Code of 1954.

ARGUMENT

I

The District Court Erred in Holding That There Was a Valid Family Partnership Composed of Taxpayers and Their Children During 1956 and a Valid Family Partnership Composed of Taxpayer Joe R. Ramos and the Children During 1957

This case represents but another phase in the history of income tax litigation which reflects the continuing effort on the part of taxpayers, by the use of an alleged family partnership, to distribute the im-

pact of taxation among members of a close family group without altering control over the income-producing property, and the attempts of the Commissioner to insure that income from property will be taxable to the substantial owner of the property and that income from personal services will be taxable to the person rendering those services. See *Toor* v. *Westover*, 200 F. 2d 713 (C.A. 9th).

The resolution of the problems as presented by the family partnership situation involves two basic principles of taxation: (1) that the assignment of the right to receive future income, whether from personal service (*Lucas* v. *Earl*, 281 U.S. 111) or from property (*Helvering* v. *Horst*, 311 U.S. 112), will not shift the burden of taxation of such income, when realized, from the assignor to the assignee (*Sellers* v. *Commissioner*, 218 F. 2d 380 (C.A. 9th)) and (2) on the other hand, that a completed gift of income-producing property will effectively shift the tax incidence of the income thereafter derived from such property to the donee. Section 704(e) of the Internal Revenue Code of 1954 (Appendix A, *infra*).

The basic test for the recognition of a partnership for tax purposes is the existence of a bona fide intent on the part of the purported partners to carry on business together and to share profits and losses. In the case of a family partnership, however, it has long been recognized that the existence of the requisite intent is subject to close scrutiny because of the great temptation to secure income-splitting advantages without conducting the business as a true partnership, with all the members thereof possessing the

attributes of true partners as is the case of a partnership established and operated by unrelated persons. 6 Mertens, Law of Federal Income Taxation, Section 35.08.

The Supreme Court, in clarifying the principles developed in this area of law by *Commissioner* v. *Tower*, 327 U.S. 280, and *Lusthaus* v. *Commissioner*, 327 U.S. 293, decided *Commissioner* v. *Culbertson*, 337 U.S. 733. In *Culbertson* v. *Commissioner*, decided June 24, 1947 (6 T.C.M. 692), the Tax Court had interpreted the Supreme Court's decision in *Commissioner* v. *Tower, supra,* and *Lusthaus* v. *Commissioner*, *supra*, as setting out two essential tests of partnerships for income tax purposes: that each partner contributes to the partnership either vital services or capital originating with him. The Fifth Circuit, on the other hand, believed that a family partnership entered into without thought of tax avoidance should be given recognition tax-wise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contribution. *Culbertson* v. *Commissioner*, 168 F.2d 979 (C.A. 5th). The Supreme Court was then faced with the question as to whether "an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case." *Commissioner* v. *Culbertson, supra,* pp. 738-739.[7] In answer to the question before it, the Court stated (pp. 739-740):

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[7] All future references to the *Culbertson* case will be to the decision of the Supreme Court unless otherwise noted.

> If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. [Footnote omitted.] The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" includes persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it. *Lucas* v. *Earl*, 281 U.S. 111 (1930); *Helvering* v. *Clifford*, 309 U.S. 331 (1940); *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949).
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> * * * A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services. *Ward* v. *Thompson*, 22 How. 330, 334 (1859). The intent to provide money, goods, labor or skill sometime in the future cannot meet the demands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income. [Footnote omitted.]

The Supreme Court, although requiring a partner to contribute either capital or services during the tax

year, rejected the Tax Court's requirement that the services be "vital" or the capital be "original". *Id.*, p. 741. In laying out the principles which were to serve as the guidelines by which courts were to determine whether or not a family partnership was to be recognized as valid, the Court stated (p. 742):

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. [Footnote omitted.]

Subsequent to the Court's decision in *Culbertson*, the Revenue Act of 1951 was enacted, at which time Congress added to Section 3797(a) of the 1939 Code [8] a

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[8] SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * *

(2) [as amended by Sec. 340(a), Revenue Act of 1951, c. 521, 65 Stat. 452] *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any

sentence providing that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. At the same time Congress added Section 191 to the Internal Revenue Code of 1939.[9]

> business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.
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> * * * *

(26 U.S.C. 1952 ed., Sec. 3797.)

[9] SEC. 191 [as added by Sec. 340(b), Revenue Act of 1951, *supra*]. FAMILY PARTNERSHIPS.

> In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be con-

That section provided that in the case of a partnership interest created by gift, the distributive share of the donee under the partnership agreement was to be included in his gross income except to the extent that such share was determined without allowing reasonable compensation for services rendered by the donor and a proportionate return to the donor on his capital.[10] The reports of the congressional committees emphasized that partnership income shoud be taxed to the real owner of the partnership interest. *Spiesman* v. *Commissioner*, 260 F. 2d 940 (C.A. 9th); *Toor* v. *Westover*, *supra*. The Report of the House Ways and Means Committee (H. Rep. No. 586, 82d Cong., 1st Sess., p. 33 (1951-52 Cum. Bull. 357, 380), stated:

> Section 312 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal

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sidered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(26 U.S.C. 1952 ed., Sec. 191.)

[10] Both of the above-mentioned additions to the 1939 Internal Revenue Code are now contained in Section 704(e) of the Internal Revenue Code of 1954.

> services is attributable to the person rendering the services.[11]

For the identical language see also S. Rep. No. 781, 82d Cong., 1st Sess. p. 39 (1951-2 Cum. Bull. 458, 486).

In the instant proceeding, the Government contends, for the reasons stated below, that the District Court erred in holding that there was a valid family partnership composed of taxpayers and their two children in 1956 and a valid family partnership composed of taxpayer Joe R. Ramos and the two children in 1957, and in failing to hold that there was a mere assignment of future income from property and services of taxpayers. The Government further con-

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[11] The enactment of the family partnership provisions noted above was not intended to legitimatize all family partnerships. *Spiesman* v. *Commissioner*, *supra*, p. 948; *Kuney* v. *Frank*, 308 F. 2d 719, 720 (C.A. 9th). The purpose of the amendments in 1951 was to insure that the income properly attributable to a capital interest in a partnership acquired as a gift would be taxed to the donee if he were the real owner of such interest regardless of the motive prompting the transfer to him. See 6 Mertens, Law of Federal Income Taxation, Sec. 35.10. As stated in H. Rep. No. 586, *supra*, p. 33 (1951-2 Cum. Bull., p. 381):

> The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of *Helvering* v. *Clifford* (309 U.S. 351).

tends that in its attempt to apply the principles of the *Culbertson* case to the instant situation, the District Court extended the doctrine of that case beyond all reasonable bounds.

The District Court, in its reliance on *Culbertson*, has placed emphasis of the intention of taxpayers to form a family partnership with their children [12] and has failed to take cognizance of the Supreme Court's requirement in *Culbertson* that there be a present contribution of capital and/or services by the partners—that reliance upon good faith intent to contribute capital or services in the future is not sufficient to validate a partnership in the present. The reasoning of the District Court here is premised on the very fallacy which was contained in the Fifth Circuit's reasoning in *Culbertson* and which led to the remand of *Culbertson* for a determination as to which of the purported partners "was there a bona fide intent that they be partners in the conduct of the cattle business, either *because of services* to be performed during those years, or because of *contributions of capital* of which they were the true owners * * *".

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[12] As disclosed by the opinion in these cases (I-R. 57-59), the District Court looked for the "true intention" of the family members much as it would have looked for a meeting of the minds to form a contract and, having found that the Ramos family in good faith had expressed the intention to form and believed that they had formed a partnership, simply terminated all further consideration of the factors determinative of the basic partnership issue. The statements of the parties as to their intention to form a partnership are unquestionably entitled to consideration, but the finding that these statements were made in good faith and expressed a "true intention" is not the end of the inquiry.

Commissioner v. *Culbertson, supra,* p. 748. (Emphasis supplied.)

The record evidence is quite clear that in spite of the *Culbertson* requirement that there be a present contribution of either capital or services, taxpayers, in their attempt to show the validity of their family partnership, have established little more than a desire to commence operating as a family partnership in 1956. The uncontroverted evidence shows that in 1956 the land, trees and improvements which comprised taxpayers' ranch and the equipment necessary for its operation were retained by taxpayers (II-R. 20-21, 155-156, 483-484); that all banking was done through taxpayers' joint checking account (II-R. 120-121, 238-239; Ex. 6); that the bookkeeping practices remained the same and separate partnership accounts were not maintained (I-R. 64); that the ranch was operated in taxpayer's name (II-R. 99; Ex. 35); and that taxpayer supervised and managed the ranch full-time (II-R. 302-305). On the other hand, neither of the children contributed any capital to the purported partnership (II-R. 20, 301-302); taxpayers' son was absent from the ranch because of military service even before the partnership was to commence operation (II-R. 18, 153, 161, 427, 429-430, 483); and taxpayers' daughter merely continued her part-time bookkeeping duties and was paid therefor (II-R. 188, 287). With the exception of the filing of a partnership return after the year ended (Ex. 42), the ranch was operated in 1956 exactly as it had been in prior years. There was no change of hands. Cf. *Haas* v. *Commissioner*, 248 F. 2d 487, 489 (C.A. 2d).

The District Court's reliance (I-R. 61) on Section 704(e)(2) of the Code and on *Culbertson* to excuse the failure of Joe S. Ramos to perform any services on the ranch for the partnership during 1956 because of his being in the Navy is misplaced. As stated by the Supreme Court in *Commissioner* v. *Culbertson, supra*, p. 739:

> Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

Here, Joe S. Ramos went into the service in November of 1955, while the partnership was not to commence its operations until January of 1956. All the purported partners knew he was going into the service and would be unable to contribute any service to the partnership once it commenced its operation. (II-R. 157-158.) Indeed, it was even understood that taxpayer was going to do his son's share of the work until he returned from military duty. (I-R. 61; II-R. 464-465.) Under these circumstances, where his only contribution was to be his services, the inability of Joe S. Ramos to render any service during the year prevents the finding of any intent to join with taxpayer as a partner.[13] *Sellers* v. *Commissioner, supra;*

[13] The District Court's intimation that Joe S. Ramos performed services for the partnership during his military tour in Hawaii (I-R. 61) is without foundation. It would be difficult to imagine any other business than a farm in which

Harkness v. *Commissioner*, 193 F. 2d 655 (C.A. 9th), certiorari denied, 343 U.S. 945; *Ritter* v. *Commissioner*, 174 F. 2d 377 (C.A. 4th). As was stated by the Court of Claims in *Cain* v. *United States*, 135 F. Supp. 516, certiorari denied, 352 U.S. 890, a case analogous to this case (pp. 519-520):

> In the instant case the plaintiff's son, Dr. Charles C. Cain, worked for his father's firm on a salary from early August until he was called into the service on December 5, 1942. At the time of signing the agreement some time after September 1, 1942, he and his father had full knowledge that he was to be called into the service; in fact, he had received a commission as probationary ensign while still in dental school prior to the signing of the agreement and was commissioned a lieutenant (jg) in the Navy on October 30, 1942. Both father and son knew that he would be called into the service. The agreement by its terms was to be effective January 1, 1943. Both plaintiff and his son knew that he would not be able to make any contribution to the partnership as such until after his return from the service. The father took pains by the terms of the agreement to provide that should the son die during his period of service all of the equipment, all of the property of the partnership should immediately revert to plaintiff.

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actual physical presence would be more necessary if Joe S. Ramos were to render income-producing services. Moreover, it is apparent from the record that taxpayer was able to and did manage the ranch without instructions from his son. (II-R. 302-305.) After all, taxpayer had farmed on his own since 1932. (I-R. 56.)

> We do not believe the facts justify a division of the profits of the firm during the period of the son's service.
>
> We have no doubt that the father had all along planned from the date of Charles' birth for him ultimately to become a member of the firm. We have no doubt that the young man from the day he reached the years of discretion probably had the same intention.
>
> We find notwithstanding the effective date recited in the agreement it remained executory until Charles C. Cain returned from the service in October 1944.[14]

Nor does Section 704(e)(2) of the 1954 Internal Revenue Code lend credence to the District Court's

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[14] The District Court attempted to distinguish *Cain* v. *United States* from this case on three grounds (I-R. 62): First, that the son had received his Naval commission prior to the signing of the partnership agreement; second, that should Cain's son have died in the service, all property of the partnership would have reverted immediately to the father; and third, that the Cain partnership was to be of a strictly personal service character. These distinctions are, however, groundless. First, all members of the Ramos family knew before the time when the partnership was to commence its operation that Joe S. Ramos was going in the service before the start of the partnership. Second, unlike the son in the Cain case, Joe S. Ramos did not even purport to own any partnership assets as Joe R. Ramos contributed none of the income-producing assets to the partnership, but retained ownership and control thereof in his wife and himself. Therefor, there was no need to agree as to the disposition of such assets should Joe S. Ramos have died while in the service. Third, although the Ramos partnership was one where capital was a material income-producting factor, the only contribution Joe S. Ramos was to make was to be his services. Thus, he was in no better position to make a contribution to the partnership while in the service than was the son in the *Cain* case.

decision that Joe S. Ramos was entitled to a distributive share of the partnership profits. Section 704(e) (2), in providing that "The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service", is not concerned with the determination of the status of a family member as a partner in a family partnership. Rather, that provision is concerned only with the computation of a partner's distributive share and is applicable only when a party who is a bona fide partner is absent due to military service. Thus, although a person may remain a partner while on military duty, the mere fact that he is in the service does not make him a partner.

Moreover, the possible application of Section 704(e) to the 1956 partnership is eliminated by taxpayers' failure to transfer any of the income-producing capital to their children. As stated by taxpayer's daughter, the partnership was to be only in the "profits or losses that would be produced by the almond trees on the land." (II-R. 302.) The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership. Treasury Regulations on Income Tax (1954 Code), Section 1.704-1 (e)(1)(v) (Appendix A, *infra*).

As for the services performed by Dolores Donaldson, the record shows that these services consisted mainly of part-time bookkeeping [15]—a job which she

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[15] As recognized by the District Court, the ranch was not a complex business organization requiring detailed accounting records and control to operate. (I-R. 64.)

had performed from the time she was in high school (I-R. 56), a job which she was able to perform even though she was employed full-time elsewhere (II-R. 98, 143, 159, 293-294), and a job for which she was compensated by the partnership (I-R. 20, 22; II-R. 287). When it is noted that taxpayer received no remuneration at all for the service which he performed on the ranch (I-R. 69), and when it is noted that taxpayer's accountant testified that the bookkeeping could have been performed by an outsider for as little as $100 or $150 a month (II-R. 520-521) and that in fact someone else must have performed the work between 1943 and 1951, when Dolores started doing it, it becomes apparent that these services are not those of a partner and do not entitle her to recognition as a partner. See *Niederkrome* v. *Commissioner*, 266 F. 2d 238, 244 (C.A. 9th).

The only other evidence of participation by the children in the 1956 partnership is the fact that their distributive shares of the reported income were paid out to them.[16] However, the bulk of this income was used by taxpayers' children to pay federal and state income taxes (I-R. 38-39, 41-42) (which, for the most part, were attributable to their partnership income) and to make their alleged contributions to the 1957 partnership (Exs. 17, 21) (which contributions went into a bank account subject to the control of taxpayers

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[16] The testimony of witnesses Lopez, Huff, Molina and Silvey, who had not done business with the purported partnership, was concerned only with the mental intention of the Ramos family to form a partnership and the family's belief that they had succeeded. (II-R. 367-390.)

solely (I-R. 41-42)). Such "withdrawals" of income do not evidence the participation necessary for recognition of the children as partners.[17] *Giffen* v. *Commissioner*, 190 F. 2d 188, 190 (C.A. 9th), certiorari denied, 342 U.S. 918; *Sellers* v. *Commissioner, supra*, p. 383; *Pogetto* v. *United States*, 306 F. 2d 76 (C.A. 9th).

As the children "contributed nothing which was of benefit to or furthered the legitimate business purposes of said partnership or the other members thereof", they should not be recognized as partners. *Pogetto* v. *United States, supra*, p. 80. And, "the attempt to use this intimate family group * * * in order to minimize a just tax burden" on taxpayers' farming business must fail. *Giffen* v. *Commissioner, supra*, p. 190. Therefore, the holding of the District Court that a valid family partnership composed of taxpayers and their two children was in existence and conducted and operated the Ramos ranch during 1956 (I-R. 53) is erroneous and should be reversed.

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[17] There is absolutely no support for the District Court's statement that "The partnership distributive shares were received and used and controlled by the partners with complete independence and have continued ever since to be so received, used and controlled" (I-R. 65) insofar as taxpapers' children are concerned. It is clear from the record evidence, as noted above, that practically all of the childrens' distributive shares for 1956 went to pay their income taxes and to make their 1957 capital contributions; that the son's distributive share was run through a joint account which could be and was drawn on by the father; that with regard to the 1957 partnership the distributive shares were paid out in amounts only slightly greater than the childern's income taxes for 1957; and that the balance of the distributive shares for 1957 was not paid out. (II-R. 181-182, 351; Exs. 26, 27, 65.)

Although the Ramos family entered into a new arrangement for the operation of taxpayers' ranch during 1957 in which Mary Ramos was no longer a partner (I-R. 65), the partnership purportedly organized for that year is subject to most of the infirmities discussed with reference to the partnership for 1956.

Taxpayer continued as manager of the partnership in 1957 and, for at least the first nine months of that year, was the only partner to render any substantial service in the production of partnership income. The land, trees and equipment which comprised the ranch remained taxpayers' property. (II-R. 20-21, 64; Ex. 1.) Nothwithstanding execution of a partnership agreement at the beginning of the year, no changes were made in the banking or the bookkeeping for the ranch until the end of March (II-R. 325, 329, 331-332), and even then the partnership bank accounts could be drawn upon only by taxpayer or Mary Ramos, who was not even a partner (II-R. 52, 91-92, 167). Joe S. Ramos worked only at the very end of the 1957 harvest (and was paid for his services) (I-R. 38, II-R. 443-444, 446-447), Dolores Donaldson continued to do essentially the same bookkeeping which she had done in prior years (II-R. 322-325), and both children received profit distributions which only slightly exceeded the taxes on their allocable shares of the 1957 partnership income.[18]

[18] Dolores Donaldson and Joe S. Ramos each recieved a part payment of $15,000 on their distributive share of the 1957 partnership profit. (Exs. 26, 27.) Dolores paid therefrom federal and state income taxes in the amount of $14,622.98 (II-R. 181-182) and Joe S. paid therefrom federal and state

To support its decision that there was a valid partnership in 1957, the District Court relied, in part, upon the factors that there was a formalization of the partnership agreement, that a rental agreement covering part of the ranch was entered into, that the name "Joe R. Ramos & Co." was used in doing business, and that each of taxpayers' children contributed $15,000 as capital. (I-R. 65-66). The record, however, demonstrates that none of these things made any real difference in the operation of taxpayers' ranch in 1957.

Formalization of the 1957 partnership was undertaken at the suggestion of taxpayers' tax accountant principally to "firm up" the arrangement which the Ramos family believed they had created in the prior year. (II-R. 487.) However, as the 1956 partnership should not be entitled to recognition as a valid partnership for federal income tax purposes, the execution of the partnership agreement and the rental agreement add nothing to the validity of the 1957 partnership unless the agreements actually resulted in a change in the economic relationship of the parties. *Kuney* v. *Frank*, *supra*.

Upon examination of the partnership agreement (Ex. 1), it is clear that the provisions concerning the operation of the ranch serve merely to emphasize taxpayer's absolute control and that any restrictions imposed thereon were merely illusory. Although taxpayers' children were purportedly equal partners and

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income taxes of $12,343.30 (Ex. 65). The balance of their distributive shares was left in the partnership account. (II-R. 351.)

together owned two-thirds of the partnership, taxpayer's management decisions were to be controlling in the event of any disagreement and he was to have exclusive control over the partnership's bank accounts.[19] The provisions of the agreement restricting the rights of all partners (including taxpayer) to withdraw their capital or transfer their interests did not affect the essential income-producing assets of the ranch as taxpayers retained ownership thereof. (Ex. 2.) Finally, the one provision of the agreement which attempted to make a realistic allocation of partnership income on the basis of services actually rendered was not followed with regard to taxpayer who actually ran the ranch during 1957 and was not compensated therefor. (I-R. 69.)

With respect to the rental agreement (Ex. 2), the record reflects that it was not followed in making the 1957 rent computation and apparently it did not express the understanding of at least one of the partners (II-R. 362-363). Furthermore, as the partnership-lessee was managed by one of the taxpayer-lessors under the partnership agreement, it is difficult to attribute any real change in the economic relationship of the parties upon execution of the lease.

Nor does the fact that the business may have been conducted in the name of "Joe R. Ramos & Co." for

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[19] The actual exercise of this control is well illustrated by taxpayer's retention of partnership receipts of $37,239.41 as advance rent without the knowledge or prior consent of his daughter (II-R. 280-281), apparently without his son's ever learning about it (II-R. 474), and in spite of the fact that the rental agreement made no provisions for such advances.

most of 1957 result in any real change here, for there is practically nothing in the record to show that anyone doing business with "Joe R. Ramos & Co." knew or relied upon the fact that it was supposed to be a partnership. While a fictitious name certificate was completed by the partners in July of 1957, it was not published until September of that year (Exs. 3, 4), and even then the sale of the 1957 almond crop was made by "Joe R. Ramos & Co." from "his ranch." (Ex. 55). The only evidence that anyone dealing with "Joe R. Ramos & Co." actually knew before the end of 1957 that it was supposed to be a partnership composed of taxpayer and his children seems to be a self-serving application for an employer's account number which was made in November. (Ex. 49.)

Finally, as for the $15,000 contributed by each of the children in 1957, the record reflects that it was neither needed nor utilized during the year and that it added nothing to the operation of taxpayers' ranch which was not already available. Even taxpayer himself would not say that the children's contributions were needed during 1957 (II-R. 126-127), and the record bears out his reluctance to so testify. For example, taxpayer withdrew over $30,000 as "advance rent" less than a month before the children contributed a like amount as capital (Ex. 7, p. B), the checking account which was opened with their contribution and a $15,000 contribution by taxpayer never fell below $40,000 (Ex. 8), and approximately $70,000 in other partnership receipts was placed in a savings account and left untouched for the remainder of the

year (Ex. 6, p. 1). When it is remembered that the children's purported capital contribution was derived from the profits of the 1956 partnership, was originally paid out of taxpayers' joint bank account, and was finally deposited in another bank account which taxpayers alone could draw upon, it appears that the only purpose for taxpayers' children to make the contribution was to create the impression of new capital being invested by the children. Indeed, there is no other reasonable explanation for the circuitous procedure followed in making the contributions.[20] Moreover, the record does not indicate that either of the children had funds sufficient to make the contributions called for by the partnership agreement when it was signed. Accordingly, the Government contends that the 1957 partnership should be held invalid for the same reasons that were put forth with regard to the 1956 partnership.

The issue as to whether a family partnership is real or fictitious has been before this Court on numerous occasions[21] and in one of these many cases, this Court used language which appears to be decisive of the issue presented here. Thus, in *Kuney* v. *Frank*, *supra*, this Court stated (p. 720):

> The courts have said, almost ad nauseam, and in various ways, that the income tax relates to reali-

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[20] See footnote 5, *supra*.

[21] See, for example, *Giffen* v. *Commissioner, supra; Harkness* v. *Commissioner, supra; Kuney* v. *Frank, supra; Niederkrome* v. *Commissioner, supra; Pogetto* v. *United States, supra; Sellers* v. *Commissioner, supra; Spiesman* v. *Commissioner, supra; Wisdom* v. *United States,* 205 F. 2d 30.

> ties, so that "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided." (*Commissioner* v. *Tower*, 1946, 327 U.S. 280, 291, 66 S. Ct. 532, 538, 90 L. Ed. 670). This is but another way of stating the principle, announced in *Helvering* v. *Horst*, 1942, 311 U.S. 112, 119, 61 S. Ct. 144, 148, 85 L. Ed. 75, that "The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." The principle has been repeatedly applied and one of its corollaries is that actual retention of the control of income and assets that produce it results in taxation of that income to him who retains the control.
>
> Yet taxpayers persist in creating paper concepts, "for tax purposes," and then going about their business as if the concepts did not exist. * * *

Taxpayer's attempt in the instant proceeding to shift the incidence of taxation over to his children without transferring to them any of the income-producing property or in any manner reducing his control thereover is blatant. Here, one need not wade through a maze of paper transactions in order to determine who was the owner of all of the operating assets used by the partnership, for the parties agree and the District Court found that the land, trees and equipment were all retained by taxpayer. (I-R. 63.) That taxpayer's purported establishment of a family partnership was merely an attempt to assign income is evident from the following testimony of his daughter (I-R. 64; II-R. 301-302):

Q. Well, what was your twenty-five percent interest in 1956?

A. In the partnership agreement. When we formed it we were going to be partners, were going to be a family partnership, all together, and whatever income we made we would share.

If we had losses, we would share them and we would pay our expenses, and whatever was left we would share twenty-five percent, my father, my mother, my brother and I. I don't think you have to own land to have a share in anything.

Q. In other words, you feel you can participate in the profits from the land without owning any portion of the land?

A. Yes.

Q. And this is the type of partnership interest you had, *just in the profits generated by assets?*

A. Profit or losses that would be produced by the almond trees on the land. (Emphasis supplied.)

Although one may avoid paying income taxes on the future income from his property by the remedy of giving the property away, taxpayers did not choose to do so. Having retained ownership of their property, taxpayers must now bear the burden of paying the tax on the income generated therefrom. To hold otherwise would be to allow taxpayers "to build up an estate in the children at the expense of the United States" (*Smith* v. *Westover*, 237 F. 2d 201, 203 (C.A. 9th)) and would be contrary to the decisions of the Supreme Court in *Lucas* v. *Earl*, *supra*, and *Helvering* v. *Horst*, *supra*, that the assignment of the right to receive future income will not shift the burden of taxation of such income, when realized, from the

assignor to the assignee. In addition, to allow the decision of the District Court to stand would be to sanction an unwarranted extension of the principles espoused by the Supreme Court in *Commissioner* v. *Culbertson, supra.*

Moreover, although the determination as to the validity of a family partnership is ordinarily a question of fact (*Commissioner* v. *Culbertson, supra*), the record evidence herein does not support the finding of the District Court that there were valid family partnerships in 1956 and 1957 and, therefore, this factual conclusion of the court is clearly erroneous and should be reversed by this Court on appeal (*Commissioner* v. *Duberstein,* 363 U.S. 278).

II

Assuming Arguendo That Valid Family Partnerships Existed During 1956 and 1957, the Income Thereof Must Be Reallocated in Order to Credit Taxpayers With a Reasonable Return on Their Capital

Having found a valid family partnership for 1956 and a valid family partnership for 1957, the District Court then had to consider what adjustments were to be made in order to establish the correct partnership income for each year and the manner in which the income was to be allocated among the partners. (I-R. 67.)

One phase of the problem which confronted the court was caused by the fact that the partnership for 1956 reported as part of its gross income the sum of $70,640.48 received for almonds which were raised on taxpayers' ranch and were sold in 1955, before the

partnership was to become operative. The Government contended that this income was earned by and taxable to the taxpayers. Likewise, the partnership for 1957 reported as part of its gross income the sum of $157,088.71 received for almonds and peaches which were raised by the 1956 partnership and which were sold and delivered to the buyer in 1956. The Government contended that this was income earned by and taxable to the 1956 partnership if a valid partnership was found to exist, and if not, was taxable to taxpayers. (I-R. 67.)

The District Court, in upholding the contention of the Government, held that taxpayers, having earned $70,640.48 for crops sold in 1955, could not defeat or avoid their tax liability by assignment of the income to the 1956 partnership, and the 1956 partners, having earned $157,088.71 for crops sold in 1956, could not defeat or avoid their tax liability therefor by assignment of the income to the 1957 partnership. (I-R. 68.)

Having determined the proper group to whom the income was taxable, the court then had to allocate the income among the Ramos family. As salary allowances had been made to Dolores Donaldson for the services which she performed for the partnership in 1956 and 1957 and to Joe S. Ramos for the services which he performed for the partnership in the last three months of 1957, the court credited Joe R. Ramos with the sum of $4,200 for 1956 and the sum of $3,150 for 1957. (I-R. 69.) Neither party takes issue with this allocation as to salary allowances.

Finally, in an attempt to allocate to taxpayers the income for 1956 allocable to the land, trees, and equipment used in the production and harvesting of the crop, the court held that (I-R. 69)—

> Since all that the partnership received in 1956 from the plaintiffs was the use of the land, trees and equipment needed for the almond orchard operation, such use should be and is treated as a rental rather than a capital contribution, and the reasonable value thereof, as expressed in the 1957 agreement, is twenty-five percent of the crop income.

After allocating 25 percent of the 1956 crop income to taxpayers, the District Court allocated equally among the members of the 1956 partnership the sum of $157,088.71 received by the 1957 partnership for crops sold in 1956, and the rental agreement entered into for 1957 by the partnership was upheld. (I-R. 53-54, 70-74.)

The Government contends that the District Court erred in allocating to the taxpayers, as owners of all the operating assets used by the partnership, only 25 percent of the crop income for 1956, in allocating equally among the 1956 partners the sum of $157,088.71, and in recognizing the rental agreement for 1957, in that by so doing so the court has failed to uphold the basic tenet of income taxation that income from services is taxable to the person who renders the services and that income from property is taxable to the person who owns or controls the property. In addition, the District Court failed to allocate the partnership income as required by Section 704(e).

As was previously discussed in Argument I, Congress attempted by the Revenue Act of 1951 to bring the taxation of "family partnerships" into line with the fundamental principles generally applied in taxing income from property and services. However, because of the possibility of distorting income by a literal application of the objective test there established, Congress also imposed certain limitations on the recognition of otherwise valid partnership agreements insofar as allocation of income was concerned. As stated in H. Rep. No. 586, *supra*, pp. 33-34 (1951-2 Cum. Bull., p. 381):

> Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner.
>
> Therefor the bill provides that in the case of any partnership interest created by gift the allocation of income according to the terms of the partnership agreement shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allow-

> ance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested.

These same limitations are now contained in Section 704(e)(2) of the 1954 Code, which provides that the distributive share of a member of a family partnership whose interest was acquired by gift or purchase from another family member shall be determined by the partnership agreement "except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital." See also Treasury Regulations on Income Tax (1954 Code), Section 1.704-1(e)(3) (Appendix A, *infra*).

By allocating to taxpayers an amount which it felt was a reasonable rental allowance for the use of the ranch's operating assets, the District Court has held that a reasonable rental allowance is a proper substitute, to protect against improper income-shifting within a family group by use of a family partnership, for the protection which Congress devised in Section 704 (e)(2) of requiring the allocation of income based upon the capital contribution of each of the partners. Moreover, there is not any factual basis on which to support the court's finding that 25 percent of the crop receipts was a reasonable rental. The only mention of this percentage as "rent" appears in the rental agreement which was to be for a period subsequent to

the 1956 crop year and there is no indication that the rental agreement for that period was arrived at as the result of arm's-length bargaining.

That capital was a material income-producing factor in the operation of the Ramos ranch cannot be denied (see Treasury Regulations on Income Tax (1954 Code), Section 1.704-1(e)(1)(iv) (Appendix A, *infra*)), and as the partners were compensated for the respective services which they performed for the partnership,[22] it is then necessary only to allocate the unallocated balance of the partnership income among the partners in accordance with their respective interests in partnership capital.

From the standpoint of capital needed for the operation of the Ramos ranch, the 175 acres of land and trees necessary to the production of the partnership income were valued at least $175,000 (II-R. 129-131), the necessary equipment was of a value of at least $15,000 (II-R. 134), and working capital in the amount of $60,000 was required (II-R. 512-513).

Viewed in a manner most favorable to taxpayers, each of the four partners would have contributed $15,000 to the needed working capital of $60,000[23]

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[22] It should here be noted that although the taxpayer-father has been credited with only nine months' salary for 1957 and the son has been credited with three months' salary at the same rate, still the record does not disclose that the father ever relinquished control over the business in any respect, and the partnershipship agreement (Ex. 1) specifically provides that his management decisions shall be final.

[23] The taxpayers argued below that receipts in the amount of some $70,000 from the 1955 crops which were received by the 1956 partnership were to belong to the partnership for

and taxpayers would have also contributed land, trees and equipment worth at least $190,000,[24] for a total capital of $250,000. Thus, in 1956, taxpayers contributed $220,000 of the total partnership capital of $250,000. Accordingly, 22/25 of the unallocated in-

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that year. Accepting taxpayer's contention for the purpose of allocating the income is to view the situation in the manner most favorable to taxpayers. To reject taxpayers' contention, as the Government contends it should be, would leave the children without a capital interest in the partnership for 1956 as they would then have no interest in any partnership assets. The mere right to participate in the earnings and profits of a partnership is not considered a capital interest in the partnership. Treasury Regulations on Income Tax (1954 Code), Section 1.704-1(e)(1)(v). If taxpayers' children had no capital interest in the 1956 partnership, Section 704(e) would not apply and all the income of the partnership, with the exception of the income allocated for services, would be allocated to taxpayers in accordance with the general rule of income taxation that income generated from property is taxable to the owner thereof. *Helvering* v. *Horst, supra.* Even if the 1955 crop receipts are considered to be assets of the 1956 partnership, the taxability of the 1955 income to the taxpayers is not affected thereby.

[24] If the partnership is recognized as being valid, then the land, trees and equipment belonging to taxpayers must be treated as if they had been contributed to the partnership. To treat them in any other manner, i.e., as having been rented to the partnership, is not supported by the evidence. The record evidence shows that no arrangements were made by the 1956 partnership to pay taxpayers any rent for the use of these assets. To treat the assets, for the purpose of allocating partnership income, as if they had been contributed to the partnership is supported by the fact that the economic effect of allowing the partnership the use of the assets without requiring any compensation therefor is the same as if they had been contributed to the partnership.

come of the 1956 partnership should be allocated to taxpayers.[25]

For the year 1957, the District Court recognized the rental agreement between the taxpayers and the partnership in determining the amount allocable to taxpayers for the use during that year by the partnership of the land, trees and equipment comprising the Ramos ranch. The Government contends that the District Court erred in so doing, rather than allocating the unallocated income to the members of the 1957 partnership in accordance with the capital contribution of each. The rent called for by the rental agreement was not arrived at by any arm's-length bargaining and there is no evidence to show that it bore any relationship to a reasonable compensation for the use of the ranch and the other assets. Indeed, it appears that the figure of 25 percent was agreed upon so that the distributive share of taxpayer, which was now to be determined on the basis of a one-third interest as Mary Ramos was not to be a partner in 1957, would remain approximately the same as it was under the 1956 partnership agreement. Moreover, as was stated in Argument I, the partners themselves did not even follow the terms of the agreement in determining the rent payable to taxpayers for 1957.[26]

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[25] The allocation of 22/25 of the 1956 partnership's unallocated income to taxpayers would apply as well to the $157,-088.71 in crop receipts received by the 1957 partnership, but taxable to the members of the 1956 partnership.

[26] Attention is also directed to Section 707(c) of the Code and Section 1.707-1(c) of the Treasury Regulations, which provide that payments by a partnership to a partner for

Again viewed in the manner most favorable to taxpayers, the record here reflects contributions of capital by each of the partners in the following amounts: Taxpayer contributed land, trees and equipment worth $190,000 (II-R. 129-131, 134) and each of the three partners contributed $15,000 for working capital (Ex. 1). Thus, in 1957 taxpayer contributed $205,-000 of the total partnership capital of $235,000. Accordingly, for the reasons stated in the discussion as to the allocation of the income of the 1956 partnership, 205/235 of the unallocated income of the 1957 partnership should be allocated to taxpayers.

CONCLUSION

For the reasons stated above, the decision of the District Court upholding the validity of the family partnerships should be reversed. Alternatively, if the validity of either or both of the partnerships is sustained on appeal, the cases should be remanded to the District Court in order to determine the income prop-

services or the use of capital shall be considered as made to a person who is not a partner only to the extent determined without regard to the income of the partnership.

erly allocable to taxpayers for the use of their assets in the operation of the ranch by the partnerships.

Respectfully submitted,

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AUGUST, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _________ day of August, 1967.

STEPHEN H. PALEY
Attorney

APPENDIX A

Internal Revenue Code of 1954:

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

* * * *

(e) *Family Partnerships.*—

(1) *Recognition of interest created by purchase or gift.*—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) *Distributive share of donee includible in gross income.*—In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) *Purchase of interest by member of family.*—For purposes of this section, an interest purchased by one member of a family from another shall be considered to be

created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

(26 U.S.C. 1964 ed., Sec. 704.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.704-1 *Partner's distributive share.*

* * * *

(e) *Family partnerships*—(1) *In general*—(i) *Introduction.* The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

* * * *

(iv) *Capital as a material income-producing factor.* For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other com-

pensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) *Capital interest in a partnership.* For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

* * * *

(3) *Allocation of family partnership income*—(i) *In general.* (a) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by

gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with (a) of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (b) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because

of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

* * * *

(26 C.F.R., Sec. 1.704-1.)

APPENDIX B

Exhibit Number	Exhibit Identified	Exhibit received or denied
Ex. 1	II-R. 65	II-R. 67
Ex. 2	II-R. 68	II-R. 72
Ex. 3	II-R. 72	II-R. 74
Ex. 4	II-R. 73	II-R. 75
Ex. 5	II-R. 52	II-R. 54
Ex. 6	II-R. 231	II-R. 233
Ex. 7	II-R. 232	II-R. 233
Ex. 8	II-R. 210	II-R. 211
Ex. 9	II-R. 170	II-R. 172
Ex. 10	II-R. 90	II-R. 90
Ex. 11	II-R. 51	II-R. 52
Ex. 12	II-R. 34	II-R. 36
Ex. 13	II-R. 178	II-R. 178
Ex. 14	II-R. 50	II-R. 51
Ex. 15	II-R. 176	II-R. 177
Ex. 16	II-R. 177	II-R. 177
Ex. 17	II-R. 49	II-R. 50
Ex. 18	II-R. 179	II-R. 179
Ex. 19	II-R. 41	II-R. 43
Ex. 20	II-R. 41	II-R. 45
Ex. 21	II-R. 45	II-R. 46
Ex. 22	II-R. 47	II-R. 48
Ex. 23	II-R. 48	II-R. 49
Ex. 24	II-R. 407	II-R. 407
Ex. 25	II-R. 75	II-R. 76
Ex. 26	II-R. 407	II-R. 407
Ex. 27	II-R. 179	II-R. 180
Ex. 28	II-R. 181	II-R. 181
Ex. 29	II-R. 181	II-R. 182
Ex. 30	II-R. 180	II-R. 181
Ex. 31	II-R. 209	II-R. 212
Ex. 32	II-R. 79	II-R. 79
Ex. 33	II-R. 55	II-R. 56
Ex. 34	II-R. 79	II-R. 80
Ex. 35	II-R. 79	II-R. 80
Ex. 36	II-R. 183	II-R. 183
Ex. 37	II-R. 192	II-R. 208

Exhibit Number	Exhibit Identified	Exhibit received or denied
Ex. 38	II-R. 211	II-R. 212
Ex. 39	II-R. 212	II-R. 216
Ex. 40	II-R. 205	II-R. 208
Ex. 41	II-R. 80	II-R. 81
Ex. 42	II-R. 54	II-R. 55
Ex. 43	II-R. 57	II-R. 57
Ex. 44	II-R. 395	II-R. 396
Ex. 45	II-R. 396	II-R. 396
Ex. 46	II-R. 208	II-R. 209
Ex. 47	II-R. 198	II-R. 208
Ex. 48	II-R. 201	II-R. 208
Ex. 49	II-R. 195	II-R. 208
Ex. 50	II-R. 204	II-R. 205
Ex. 51	II-R. 408	II-R. 412 (denied)
Ex. 52	II-R. 408	II-R. 412 (denied)
Ex. 53	II-R. 396	II-R. 396
Ex. 54	II-R. 23	II-R. 24
Ex. 55	II-R. 59	II-R. 60
Ex. 56	II-R. 218	II-R. 220
Ex. 57	II-R. 220	II-R. 220
Ex. 58	II-R. 221	II-R. 222
Ex. 59	II-R. 221	II-R. 222
Ex. 60	II-R. 221	II-R. 222
Ex. 61	II-R. 81	II-R. 81
Ex. 62	II-R. 398	II-R. 399
Ex. 63	II-R. 223	II-R. 223
Ex. 64	II-R. 399	II-R. 400
Ex. 65	II-R. 400	II-R. 401
Ex. 66	II-R. 401	II-R. 402
Ex. 67	II-R. 412	II-R. 412
Ex. 68	II-R. 36	II-R. 36
Ex. 69	II-R. 37	II-R. 37
Ex. 70	II-R. 402	II-R. 403
Ex. 71	II-R. 402	II-R. 403
Ex. 72	II-R. 227	II-R. 227
Ex. 73	II-R. 403	II-R. 404
Ex. 74	II-R. 225	II-R. 226 (denied)
Ex. 75	II-R. 228	II-R. 229
Ex. 76	II-R. 404	II-R. 404

Exhibit Number	Exhibit Identified	Exhibit received or denied
Ex. 77	II-R. 404	II-R. 404
Ex. 78	II-R. 405	II-R. 406
Ex. 79	II-R. 405	II-R. 406
Ex. 80	II-R. 406	II-R. 406
Ex. 81	II-R. 82	II-R. 412 (denied)
Ex. 82	II-R. 82	II-R. 412 (denied)
Ex. 83	II-R. 82	II-R. 412 (denied)
Ex. 84	II-R. 82	II-R. 412 (denied)
Ex. 85	II-R. 82	II-R. 412 (denied)
Ex. 86	II-R. 82	II-R. 412 (denied)
Ex. 87	II-R. 354	II-R. 355
Ex. 88	II-R. 391	II-R. 392
Ex. 89	II-R. 392	II-R. 395
Ex. A	II-R. 185	II-R. 185

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